-- in the NPRM. Reliance on limited, self-executing discovery should greatly simplify the process.

In addition, the Commission should decline to adopt its proposal to substitute Bureau-generated data requests for discovery.[37/] The Commission will, of course, retain broad discretion to request the production of additional information and all parties will have every incentive to comply with such requests. However, there is no guarantee that the Bureau's data requests will satisfy the needs of all parties. Indeed, parties with adverse interests are in the best position to determine what additional data that they need. The Commission can best rely upon the adversarial process to produce the most complete record.

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With this set of core procedures in place, the Commission should eliminate the remaining procedures -- separated Trial Staff,[38/] proposed findings, reply findings, cross-examination and oral argument[39/] -- now contained in the rules. Adopting

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37/ Id., ¶ 35.

38/ The use of separated Trial Staff would be appropriate if the Commission or the Bureau intends to act in the role of a party as well as decisionmaker. In these circumstances, due process requires the separation of the advocate from the judge.

39/ Although the rules need not specify the availability of cross-examination and oral argument, the Commission should retain the discretion to make these tools available if circumstances warrant.

these proposals will result in a more efficient represcription procedure that will also ensure the availability of a complete record upon which the Commission may prescribe an authorized rate of return.

II. THE COMMISSION SHOULD MODIFY SUBSTANTIALLY THE SUBSTANTIVE REQUIREMENTS CONTAINED IN ITS PART 65 RULES.

The current Part 65 rules contain a plethora of substantive filing requirements that can largely be jettisoned. For example, Part 65 requires the production of certified copies of state rate of return awards,[40/] specified cost of equity calculations -- both discounted cash flow ("DCF") calculations based upon particular methodologies and comparable firms analyses,[41/] cost of debt by debt issuance[42/] and capital structure.[43/] Much of this required information is either unnecessary or should not, for policy reasons, be enshrined in the rules in the first instance. The

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40/ 47 C.F.R. § 65.200.

41/ 47 C.F.R. §§ 65.303, 65.400.

42/ 47 C.F.R. § 65.301.

43/ 47 C.F.R. § 65.300.

Commission correctly proposes to eliminate certain requirements -- such as the filing of historical DCF calculations and comparable firms analyses.[44/] On the other hand, the Commission proposes to expand the data reporting requirements -- from the Bell companies, as provided for in the current rules, to all Tier 1 carriers, for example.[45/] The variety of somewhat conflicting proposals contained in the NPRM strongly suggests that the substantive requirements set forth in Part 65 are a fertile ground for reform.

Conceptually, a represcription proceeding consists of three determinations: capital structure; cost of debt; and cost of equity. The first two are objectively determinable under a proper set of guidelines. Thus, the Commission's rules should specify those guidelines. The third area is highly judgmental and, indeed, is the focus of the bulk of the expert testimony submitted in prior represcription proceedings. The rules regarding cost of equity determinations should provide the parties with maximum flexibility to suggest and defend particular methodologies and their results. Moreover, this

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44/ NPRM, ¶ 56.

45/ E.g., id., ¶¶ 41, 85.

discipline is constantly evolving. Engraving particular methodologies in the rules is inappropriate. This approach may also, in some sense, prejudge the outcome of a represcription proceeding, by according undue weight to a particular cost of equity methodology. Rochester's proposals in each area are set forth more fully herein.

A. The Commission Should Utilize Bell Operating Company Data in Determining a Composite Industry Capital Structure.

In the 1990 represcription, the Commission utilized Bell Regional Holding Company ("RHC") data in developing a composite capital structure. It rejected the use of Bell Operating Company ("BOC") data for this purpose, largely on the grounds that BOC capital structures are subject to manipulation.[46/] This was a mistake that the Commission should rectify.

In addition, the Commission proposes to expand the universe of reporting companies to all Tier 1 carriers, and, possibly, the National Exchange Carrier Association ("NECA").[47/] Such an expansion would tremendously increase

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46/ Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, CC Dkt. 89-624, Order, 5 FCC Rcd. 7507, 7510, ¶ 31 (1990) ("1990 Represcription Order").

47/ NPRM, ¶¶ 41, 85.

the burden on smaller exchange carriers and produce little additional useful information.[48/]

In prescribing an authorized rate of return, the Commission's task is to determine the cost of capital for interstate access, the services provided by exchange carriers that it regulates.[49/] Overall, exchange carrier capital structures best approximate a hypothetical interstate access firm. Moreover, the BOCs represent over 80% of the nation's access lines and thus constitute a representative subset of the exchange carrier universe.

Despite the Commission's conclusion to the contrary in the 1990 represcription,[50/] the use of composite RHC data is inappropriate. The RHCs are substantially diversified enterprises that engage in a variety of businesses in addition to telephone service.[51/] Thus, the capital structures of the

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48/ If parties other than the RHCs wish to submit such information or if the Bureau wishes to compile this information from publicly available data, i.e., Forms M, the Commission should not preclude such efforts.

49/ See CC Dkt. 89-624, Responsive Submission of Rochester Telephone Corporation at 5-6 (March 27, 1990).

50/ 1990 Represcription Order, 5 FCC Rcd. at 7517-19, ¶¶ 83-87; 98-102.

51/ The same is also true of at least the larger non-Bell exchange carriers. Rochester, for example, is engaged in the cellular, interexchange and telecommunications equipment businesses. In 1991, these activities accounted for approximately 31% of Rochester's consolidated revenues.

RHCs do not represent an adequate proxy for a hypothetical interstate access firm.

Moreover, the Commission's expressed fear that BOC capital structures are subject to manipulation[52/] is groundless. The BOCs issue their own debt and thus have capital structures independent of their parent companies. The incentive to engage in manipulation does not exist. State regulatory bodies and debt rating agencies scrutinize BOC capital structures and the BOCs cannot achieve any sustainable benefit by engaging in manipulative behavior. The Commission's proposed use of either a "conclusive" capital structure or one based upon RHC data[53/] would produce a lower equity ratio than would be appropriate for a "pure-play" interstate access firm. This could effectively deny to exchange carriers the opportunity to earn a reasonable return on capital prudently invested in the provision of interstate access services. This, of course, the Commission may not do.[54/]

52/ 1990 Represcription Order, 5 FCC Rcd. at 7510, ¶ 31.

53/ NPRM, ¶ 84.

54/ See, e.g., Illinois Bell Telephone Co. v. FCC, 911 F.2d 776 (D.C. Cir. 1990); Jersey Central Power & Light Co. v. FERC, 810 F.2d 1168 (D.C. Cir. 1987). See also FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944); Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n, 262 U.S. 679 (1923).

In addition, there is no reason for the Commission to expand the universe of exchange carriers upon which it would determine a composite capital structure. The BOCs represent over 80% of the nation's access lines and thus provide a representative sample of the exchange carrier universe. Indeed, the BOCs, together with the General Telephone Operating Companies, effectively define the exchange carrier universe. Utilizing data from the remaining Tier 1 companies would not significantly alter the resulting composite capital structure. The use of such data would, moreover, impose substantial burdens on the smaller Tier 1 companies and Bureau staff. If the Commission were to impose additional reporting requirements on companies such as Rochester, the burden would be clear. Similarly, if the Commission were to utilize additional Form M data -- the source upon which the Commission should rely -- its Staff would need to analyze data from approximately an additional 30 study areas. Given the marginal change in results that such a requirement would cause, the burden would far outweigh any benefit that could be obtained thereby.

B. The Commission Should Establish a Composite Cost of Debt Based Upon BOC Form M Data.

The current rules require the submission of cost of debt

data from the BOCs on an issuance-by-issuance basis.[55/] This requirement creates an enormously burdensome, yet unnecessary, exercise. The Forms M of reporting companies contain all the information necessary to compute a composite cost of debt. Moreover, this information is readily available and conforms to the Uniform System of Accounts. The Commission should utilize BOC data to parallel the data that Rochester believes the Commission should utilize to establish a composite capital structure.[56/]

The use of Form M data would simplify the represcription process. It would obviate the need for the Commission separately to determine the cost of short-term and long-term debt[57/] or determine a general corporate cost of debt.[58/]

55/ 47 C.F.R. § 65.301.

56/ If the Commission wishes, it may use the same approach to determine the cost of preferred stock. See NPRM, ¶¶ 81-82. Separately identifying the cost of preferred stock may, as a practical matter, be unnecessary. To Rochester's knowledge, none of the BOCs (or RHCs) have preferred stock outstanding. Although Rochester does, preferred stock constitutes an insignificant portion (less than 4%) of its capital structure.

57/ 47 C.F.R. § 65.301.

58/ NPRM, ¶ 80.

Rochester does not suggest that the Commission foreclose this alternative entirely. So long as it is not tied to a "conclusive" capital structure, this approach to determining the cost of debt may have some merit.

Thus, the Commission should rely upon BOC Form M data in establishing a composite cost of debt.

C. The Commission's Rules Should Contain Maximum Flexibility for Approaches To Determining the Cost of Equity.

The current Part 65 rules require the submission of voluminous data regarding the cost of equity. Carriers must submit certified copies of state rate of return awards, DCF calculations and comparable firms analyses.[59/] The rigidity prescribed in the rules is totally unnecessary. In the 1990 represcription, the Commission recognized this state of affairs by waiving its rules to the extent necessary to permit parties to submit alternative methodologies that they deemed appropriate.[60/] The Commission should recognize this fact by eliminating those rules that specify particular cost of equity methodologies. Determining the cost of equity is a highly judgmental exercise, even among experts in the field, and is an evolving area of academic study. Specifying particular methodologies in the Part 65 rules is, therefore, unnecessarily constraining and may bias the outcome of any represcription proceeding. On this basis, the Commission should decline to specify any cost of equity methodologies in its Part 65 rules.

59/ 47 C.F.R. §§ 65.200, 65.303, 65.400.

60/ Interim Represcription Order, 5 FCC Rcd. at 202, ¶¶ 47-48.

In the 1990 represcription, the Commission plainly expressed its preference for the constant growth variant of the classic DCF model. Indeed, the Commission gave almost conclusive weight to its results.[61/] The Commission, however, expresses some interest in other cost of capital methodologies, particularly risk premium approaches, such as the capital asset pricing model ("CAPM").[62/] The Commission's interest in alternatives to the DCF model is encouraging. The Commission apparently recognizes the utility of alternative approaches to estimating the cost of equity. In addition to these two approaches, other techniques -- such as spanning and cluster analyses and arbitrage pricing theory -- are being explored and are gaining acceptance in the academic literature. Such approaches may well provide useful insights to the Commission in determining exchange carriers' cost of equity. Not only are new techniques being explored, new sources of data are coming into existence. The Institutional Brokers' Estimate Service, for example, which the Commission utilized in the 1990 represcription, did not exist prior to 1987.

The Commission's rules should recognize the evolutionary nature of this discipline. The best way to accomplish this result is to decline to codify any particular cost of equity

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61/ 1990 Represcription Order, 5 FCC Rcd. at 7528-29, ¶ 187.

62/ NPRM, ¶¶ 68-75.

methodology in the Part 65 rules. The Commission should permit parties to propose and defend any methodology that they wish to utilize. The Commission can certainly expect parties with antagonistic interests to suggest a variety of approaches. The existence of such flexibility in the rules will result in a robust record for the Commission's consideration.

Moreover, specifying a particular methodology in the rules could well indicate a prejudgment of the central issue. A particular methodology, if codified in the rules and relied upon in the past, could well become the preferred methodology and be accorded undue weight. The state of learning in the field does not warrant this result. It could also cause the Commission to rely, in the future, upon approaches that have become outdated or otherwise rendered inappropriate for use in a particular represcription proceeding.

For the same reasons, the Commission should not adopt rules that would effectively reject cost of equity adjustments to take into account flotation costs and quarterly compounding of dividends.[63/] These areas are certainly worthy of further exploration and analysis, despite the Commission's rejection of

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63/ Id., ¶¶ 64-66.

them in the 1990 represcription.[64/] The rules should not foreclose their consideration for all time.

The Commission's rules should provide maximum flexibility for parties to propose and defend alternative methodologies for estimating the cost of equity. This approach would enusre the compilation of a complete record upon which the Commission could prescribe an authorized rate of return.

III. THE COMMISSION SHOULD ABANDON ANY ATTEMPT TO ENFORCE RATE OF RETURN PRESCRIPTIONS RETROACTIVELY.

The Commission's current enforcement philosophy is to attempt to enforce its rate of return prescriptions retroactively, by ordering refunds.[65/] The courts have squarely held that this approach is inconsistent with the statutory framework enacted by Congress. The automatic refund rule has been invalidated.[66/] The courts have disapproved refund orders based upon basket-by-basket overearnings.[67/] The courts have finally unequivocally held that the Commission

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64/ 1990 Represcription Order, 5 FCC Rcd. at 7515, ¶ 72; 7516, ¶ 76.

65/ E.g., 47 C.F.R. § 65.703.

66/ Am. Tel. & Tel. Co. v. FCC, 836 F.2d 1386 (D.C. Cir. 1988).

67/ Ohio Bell Tel. Co. v. FCC, 949 F.2d 864 (6th Cir. 1991).

may not order refunds without complying with the procedural requirements of sections 204 and 205 of the Communications Act.[68/]

In the NPRM, the Commission obliquely acknowledges this precedent by proposing to abandon its automatic refund rule and to rely upon its tariff review and complaint processes.[69/] The NPRM nonetheless suggests that, under New England Telephone,[70/] the Commission possesses some residual authority to "order carriers to make refunds when they violate a rate of return prescription."[71/] The Commission also entertains the novel concept that it may enforce a rate of return prescription through forfeitures.[72/] These notions are as wrong as they are dangerous. The Commission should explicitly reject these tentative conclusions. In their place, the Commission should rely upon the tariff review and complaint processes to enforce its rate of return prescriptions on a prospective basis only.

68/ Ill. Bell Tel. Co. v. FCC, No. 89-1365, slip op., _____ F.2d _____ (D.C. Cir. June 16, 1992).

69/ NPRM, ¶ 98.

70/ New England Tel. & Tel. Co. v. FCC, 826 F.2d 1101 (D.C. Cir. 1987).

71/ NPRM, ¶ 98.

72/ Id.

A. The Commission May Not Retroactively Enforce a Rate of Return Prescription.

American Telephone & Telegraph Co. explicitly invalidated the Commission's automatic refund rule. There, the D.C. Circuit concluded that this rule would, over the long run, guarantee that exchange carriers' realized returns would approach confiscatory levels.[73/] The Sixth Circuit held, in Ohio Bell, that a basket-by-basket refund order is arbitrary and capricious, for essentially the same reasons.[74/] Illinois Bell is even more explicit. There, the D.C. Circuit held that the Commission may not order refunds unless it first complies with the procedural requirements of sections 204 and 205 of the Communications Act, i.e., its refund authority is limited to rates that were suspended when the refunds were ordered.[75/]

The Commission, nonetheless, believes that its section 4(i) authority, as interpreted in New England Telephone, is a sufficient basis for it to order refunds. This interpretation of New England Telephone is wrong. The rates at issue in that

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73/ Am. Tel. & Tel. Co., 836 F.2d at 1390-91.

74/ Ohio Bel Tel. Co., 949 F.2d at 873.

75/ Ill. Bell Tel. co., slip op. at 6-10.

case had been suspended.[76/]

These results should not be surprising. In the first instance, such refund orders violate the rule against retroactive ratemaking. Second, under the Commission's current procedures, rates that merely comply with an outstanding Commission rate of return prescription may not be carrier-initiated and thus not subject to a refund order. Finally, even if the Commission possessed some authority retroactively to examine carrier rates, a refund would constitute an unlawful remedy.

1. An Automatic Refund Rule Violates the Rule Against Retroactive Ratemaking.

A central principle of ratemaking is that carriers may not establish current rates to recoup past losses, nor may a regulatory body establish rates to return past gains to ratepayers.[77/] An automatic refund rule, however,

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76/ Moreover, the majority's holding in New England Telephone was compellingly criticized as a radical departure from the well-established filed rate and retroactive ratemaking doctrines. New England Tel. & Tel. Co., 826 F.2d at 1111-20 (Buckley, J. dissenting). The courts have refused to extend New England Telephone beyond its narrow holding. See, e.g., Am. Tel. & Tel. Co., 836 F.2d at 1392-93; Ohio Bell Tel. Co., 949 F.2d at 873.

77/ See, e.g., Arkansas Louisiana Gas Co. v. Hall, 453 U.S. 571 (1581); Arizona Grocery Co. v. Atchison, T. & S.F. Ry. Co., 284 U.S. 370 (1932).

accomplishes precisely this result. It plainly requires that current rates be set to return past overearnings.

In addition, without a compensating mechanism to address underearnings, an automatic refund rule is highly unfair. As the Commission has recognized, forecasting anticipated returns is an inexact science at best:

> The use of telecommunications services is tied to the well-being of the national economy. Forecasts, even at macro-economic levels, have been somewhat lacking in accuracy and are not expected improve any time soon.[78/]

An agency cannot, consistent with accepted ratemaking principles, require that a carrier's forecasts "be flawless in retrospect rather than reasonable when made."[79/] An automatic refund rule violates this standard.

Finally, even in those circumstances where the Commission arguably possesses the authority to order refunds, the Commission must apply equitable principles in determining whether to order refunds.[80/] An automatic refund rule does

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78/ Am. Tel. & Tel. Co., 78 FCC 2d 1296, 1316 (1981).

79/ Delmarva Power & Light Co. v. FERC, 770 F.2d 1131, 1142 (D.C. Cir. 1985).

80/ See, e.g., West Virginia PSC v. DOE, 777 F.2d 31, 35 (D.C. Cir. 1985); RCA Global Communications, Inc. v. FCC, 717 F.2d 1429, 1437 (D.C. Cir. 1983); Las Cruces TV Cable v. FCC, 645 F.2d 1401, 1407 (D.C. Cir. 1981); Moss v. CAB, 521 F.2d 298, 303-09 (D.C. Cir 1975), cert. denied, 424 U.S. 966 (1976).

not come close to complying with this requirement and may not, therefore, be imposed.

2. Under the Commission's Current Procedures, Access Rates May Not Be Carrier-Initiated and, Therefore, May Not Be Subject to Refund or Damage Awards.

During the annual access tariff proceedings, the Bureau typically examines proposed rates, orders changes, and makes it clear that tariff revisions that do not conform to the Bureau's suggestions will be rejected. Yet, the Bureau expressly denies that it is prescribing rates.[81/] In these circumstances, a court could well conclude that the resulting rates are, in fact, agency prescribed.

In Moss v. CAB,[82/] the D.C. Circuit addressed a similar set of facts. There, the Civil Aeronautics Board established a detailed model that it expected airline carriers to follow in establishing rates and stated that it would reject nonconforming tariffs. The court held that it would be "blinking [at] reality" to conclude that such rates were not

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81/ See, e.g., 1992 Annual Access Tariff Filings, CC Dkt. 92-141, Memorandum Opinion and Order, 7 FCC Rcd. 4731, 4755-56, ¶¶ 85, 89 (1992).

82/ 430 F.2d 891 (D.C. Cir. 1970).

agency-made.[83/] The Commission's procedures are strikingly similar. Were a court to conclude that interstate access rates were, in fact, agency-prescribed, awards of refunds or damages would be precluded.[84/]

3. Even if the Commission Could Properly Order Retrospective Relief, a Refund Order Would Constitute an Improper Remedy.

In defending its refund authority, the Commission appears to equate a refund of an alleged overcharge with damages sustained by a customer. The case law, however, is to the contrary. A customer is entitled to recover only the damages it sustains, not the full amount of the overcharge:

> Under these complaint provisions protestants may seek actual damages if they believe the rates are unlawfully high. ... [T]he complaint procedure shifts the burden of proof onto the aggrieved party and may restrict his ultimate relief to actual damages rather than the full overcharge that would have been available had the FCC ordered an investigation.[85/]

Moreover, the case law regarding the circumstances in which the Commission may order refunds is clear. The

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83/ 430 F.2d at 897.

84/ Arizona Grocery, supra 284 U.S. at 381; MCI Telecommunications Corp. v. Am Tel. & Tel. Co., 85 F.C.C. 2d 994, 1000 (1981).

85/ Aeronautical Radio, Inc. v. FCC, 642 F.2d 1221, 1235 n.34 (D.C. Cir. 1980); see also Southern Ry. Co. v. Seaboard Allied Mining Co., 442 U.S. 444 (1979).

Commission may only order refunds where it has suspended rates under section 204 and subjected those rates to investigation. As the D.C. Circuit has succinctly summarized the Commission's refund authority:

> Thus, under the plainest guide to congressional intent - the words of the statute - the Commission's authority to order refunds follows the exercise of the suspension process under § 204 (a)(1). ... Moreover, this does not mean that the Commission cannot take action to correct an unreasonable rate if it fails to order a suspension. It can still do so, but must do so under § 205, which speaks only prospectively.[86/]

The Commission's notions that it possesses a broader refund authority is incorrect. The Commission should design its enforcement procedures accordingly.

B. The Commission May Not Enforce a Rate of Return Prescription Through Fines or Forfeitures.

In the NPRM, the Commission states that it may enforce a rate of return prescription through fines of up to $12,000 per day.[87/] That view is incorrect. Section 205(b) authorizes the Commission to levy fines against a carrier that "knowingly fails or neglects to obey any order made" pursuant to section 205(a). A rate of return prescription, however, is not an

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86/ Ill. Bell Tel. Co., slip op. at 7.

87/ NPRM, ¶ 98.

enforceable order; rather it is merely a guideline. Section 205(a), in fact, expressly mentions only one type of order -- a cease and desist order. However, it implicitly covers another type of order -- one prescribing a "charge ..., classification, regulation or practice."[88/] A rate of return prescription falls into neither of these categories.[89/] Section 205 does not authorize the Commission to levy fines to enforce a rate of return prescription.[90/]

C. The Commission Should Rely Upon Its Tariff Review and Complaint Processes To Enforce Its Rate of Return Prescriptions.

Having defended its refund authority, the Commission ultimately concludes that it should utilize the tariff review and complaint mechanisms to enforce its rate of return prescriptions.[91/] This conclusion is correct. Rochester would add only that the Commission should enforce such prescriptions

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88/ 42 U.S.C. § 205(a).

89/ Cf. Northern Natural Gas Co. v. FERC, 827 F.2d 779, 786, 786 n.15 (D.C. Cir. 1987) (en banc) (distinguishing "rate" from "rate of return").

90/ The Commission also fails to take into account the knowledge requirement of section 205(b). Any type of automatic forfeiture rule would ignore this standard.

91/ NPRM, ¶ 98.

on a prospective basis only; the Commission does not possess generalized authority to order retrospective relief.

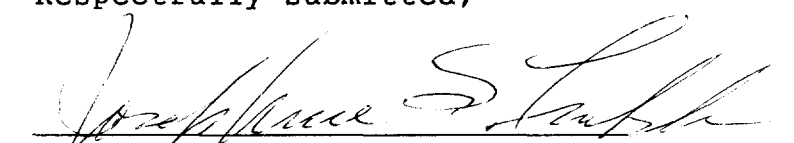
The tariff review and complaint procedures, moreover, constitute sufficient tools for the Commission to ensure compliance with its rate of return prescriptions. Each year, most of the larger rate of return regulated carriers must file their proposed access charges for the upcoming tariff year. As a part of the Bureau's review of those tariff filings, it may -- and does -- examine whether rates have been set to earn no more than the authorized return.

Moreover, interstate access customers may file section 205 complaints if they believe that rates are unreasonably high. These customers are, for the most part, large, sophisticated interexchange carriers or high volume special access users. Companies such as AT&T can be expected to safeguard their own interests. The complaint procedure is a weapon in their arsenal and the Commission can rely upon its existence to ensure compliance with an outstanding rate of return prescription.

Conclusion

For the foregoing reasons, the Commission should reform its rate of return represcription and enforcement procedures as set forth herein.

Respectfully submitted,



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